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Disclosure of Preliminary Merger Negotiations Under Rule 10b-5

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DISCLOSURE OF PRELIMINARY MERGER NEGOTIATIONS UNDER RULE 10b-5

The corporate community has been mired for the last several years in one of its cyclical preoccupations with mergers and other acquisitive ventures. In 1985 alone, $72 billion changed hands in mergers and acquisitions involving publicly traded corporations.[1] Rule 10b-5[2], which was promulgated under section 10[3] of the Securities Exchange Act of 1934 (the Exchange Act), requires the eventual disclosure of both the existence of negotiations and the terms of a proposed merger. The participants in mergers and acquisitions usually attempt to avoid early disclosure of the negotiations, because of its dramatic effect on the market and the negotiating process.[4] Despite management's attempts, however, the news usually leaks out. Substantial increases in price and volume of shares traded occur before any public announcement is made. Investors' subsequent fortunes depend on how early they discover the negotiations and the extent to which they draw accurate conclusions from the increased market activity.

The law regarding disclosure of merger negotiations is unsettled.[5] Re-

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1. *Decline in Public Targets*, MERG. & ACQUIS., Sept./Oct. 1986, at 24.

2. 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

3. 15 U.S.C. § 78j(b). Section 10 of the Securities Exchange Act of 1934 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

4. Freund, *Mergers and Acquisitions*, Nat'l L.J., Nov. 11, 1985, at 13, col. 1. Established companies are in great demand today. The parties to the negotiations have to worry about competing offers once the deal is disclosed. The parties' goal is to "negotiate in private in order to arrive at a point where, when the world finds out something's happening, it's as close to a done deal as possible—with the undone parts getting taken care of posthaste." *Id. See infra* notes 20–23 and accompanying text.

5. *See SEC Issues Report to Clarify Policy on Disclosure of Merger Negotiations*, 17 Sec. Reg. & L. Rep. (BNA) 1229 (1985); *SEC Opposes Price Structure Rule in Public Company Mergers*, 17 Sec. Reg. & L. Rep. (BNA) 1395 (1985).

cently, the Third Circuit held that merger negotiations are immaterial as a matter of law, and need not be disclosed until agreement is reached on price and post-merger structure, regardless of whether the corporation has made any previous statements on the subject.[6] The SEC vigorously disputes that contention,[7] and has found support from the Sixth Circuit in *Levinson v. Basic, Inc.*,[8] which held that a "no corporate development" statement when merger negotiations are occurring is misleading.

The present formulation of the law takes an overly simplistic approach to disclosure during merger negotiations. This Comment argues that disclosure rules should be standardized to accommodate competing concerns related to investor protection and predictability for management.

I. BACKGROUND

A. *The Market Impact of Merger Negotiations: Empirical Evidence*

Merger negotiations seldom remain a secret for long after they begin. Unusual market activity immediately preceding announcements of mergers and takeovers is widely recognized as the rule, not the exception. The prevalence of unusual market activity and the size of the market's reaction have been confirmed empirically.

In one study by Keown and Pinkerton, the daily returns on stock of 195 successfully acquired firms were examined for the period of three months before through one month after public announcement.[9] The study showed that, on the average, significant abnormal returns[10] started to accumulate about one month before the first public announcement. "Uncontrolled abuse of Rule 10b-5" began five to eleven days prior to the announcement date.[11] Approximately half of the market's reaction to the merger occurred before any disclosure was made.[12] Likewise, volumes of shares traded over

6. Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985).

7. Memorandum of the Securities and Exchange Commission, Amicus Curiae, in Connection with Pending Petition for Rehearing and Suggestion of Rehearing In [sic] Banc, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, 106 S. Ct. 797 (1986) [hereinafter SEC Amicus Brief].

8. 786 F.2d 741 (6th Cir. 1986).

9. Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981). Unlike previous studies, which had centered upon cumulative abnormal returns, the authors calculated a daily rate of return on the sample, and then compared it to a daily market model to estimate abnormal returns. They hypothesized that systematic abnormal returns would be expected if there were leaks of the merger information. *Id.* at 858.

10. See *infra* note 28 for a discussion of abnormal returns.

11. Keown & Pinkerton, *supra* note 9, at 863.

12. *Id.* at 866. Most of the remaining reaction occurred on the disclosure date. Only five percent occurred after the disclosure date. *Id.*

Another study that examined the daily price changes yielded essentially the same results but with a different emphasis. *See* Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980) (When merger proposal is announced but management vetoes it, stock of target the three week period before public announcement were at least 100 percent higher than for the same period three months earlier.[13]

Another study by the same authors compared the trading patterns of merger stocks in general with the trading patterns of those companies involved in the Antoniu Newman insider trading cases.[14] The study indicated that the price changes in the Antoniu Newman sample were typical of merger candidates.[15] It indicated that, on the average, 62 percent of the premium offered by the merger was exhausted prior to the first public announcement, compared to 52.6 percent for the master sample.[16]

Both studies concluded that, to the extent the abnormal returns were exploited by insiders, the trading was illegal.[17] It is likely that a significant portion of the abnormal returns, however, did not result from trading directly on information from inside sources.[18] Once the price of the stock starts to rise, market observers, who may have already identified the target as a likely acquisition candidate, draw the obvious conclusions and start to purchase the stock.

In addition, early disclosure of inside information about merger negotiations figures prominently in the calculations of the investment bankers

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corporation shows permanent upward revaluation). For less systematic evidence of widespread trading, see Merjos, *Who Knew What When?*, BARRONS, July 19, 1982, at 32.

13. Keown & Pinkerton, *supra* note 9, at 863. Not surprisingly, very little of this trading was conducted directly by registered insiders. *Id.* The study also found little significant differences between the trading patterns of over the counter stocks and stocks listed on a registered exchange. Both samples exhibited abnormal returns. *Id.* at 864–65 (Figures 3 and 4).

14. Keown, Pinkerton, Young & Hansen, *Recent SEC Prosecution and Insider Trading on Forthcoming Merger Announcements*, 13 J. BUS. RES. 329 (1985). Adrian Antoniu worked in the merger department of Morgan Stanley. He was convicted of passing information concerning 18 merger candidates to his co-conspirators, who purchased stock and split the subsequent profits with him. *Id.* at 330.

15. *Id.* at 335.

16. *Id.* at 333–35.

17. Keown & Pinkerton, *supra* note 9, at 866; Keown, Pinkerton, Young & Hansen, *supra* note 14, at 335. Other commentators have been critical of this contention, as well as of Keown and Pinkerton's entire approach. They assert that Keown and Pinkerton disregard the "plausible alternative hypothesis" that price changes are caused by responses to public information that increases the probability of a takeover. The commentators also suggest that characterizing public announcement as something that happens on a single day is naive. Public disclosure, they say, usually operates as a series of events that increase the probability of a takeover. *See* Jensen & Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5, 14 n.6 (1983).

Up until about two weeks before the public announcement, that conclusion seems warranted. It is unlikely, however, that public information would produce the dramatic price increases and abnormal returns that take place for two weeks prior to disclosure.

Furthermore, even if effective public announcement is prolonged over several days, that state of affairs involves a significant amount of unfairness to investors who are not in a position to know about the events preceding public disclosure on the national level.

18. *See* Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 224 (1985). *See also* Fleischer, Mundheim & Murphey, *Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

employed to calculate a premium price to offer shareholders in a tender offer. Investment bankers generally base the stock price from which they calculate the premium on the market value at a point ranging from four months to two weeks before the first public disclosure, solely to compensate for possible leaks of the negotiations.[19]

B. The Negotiation Scenario

Although the hostile contest for control is more prominent in the public eye, most acquisitions are friendly, negotiated deals.[20] Because of the publicity problems, once the negotiations begin, they usually proceed as rapidly as possible to agreement in principle.[21] After agreement is reached, mergers may proceed to closing at varying rates of speed. Increasingly, the agreement stipulates some sort of penalty if one side backs out.[22]

Unlike the parties to a hostile tender offer, both the buyer and the seller in a friendly acquisition have a similar interest in secrecy; in particular, both sides want to avoid public disclosure until the agreement to merge is finalized and binding. Public disclosure produces an immediate increase in the price of the target's stock.[23]

Premature disclosure will lessen the apparent size of the premium, thus increasing the risk that shareholders will not approve the transaction. If an overly optimistic market miscalculates the anticipated size of the premium, the share price may rise above the price that the buyer was willing to pay. The buyer may be forced to raise the price, or may abandon the deal altogether. Disclosure may act as a catalyst for alternate bids on less favorable terms for the seller's management. It may also serve to put the target up for auction on more favorable terms. This may be advantageous for the target, but for the acquiring corporation it represents great trouble and expense with no return.

At the same time, management faces constant, and often intense pressure to disclose information or confirm rumors. The ability of corporate management to control disclosure in such situations is often illusory. Analysts,

19. *See* Penn, *Premiums, What Do They Really Measure?*, MERG. & ACQUIS., Fall, 1981, at 30. *See also Profits from Picking Merger Targets*, BUS. WK., Jan. 14, 1980, at 101; Laws, *Risk and Reward*, BARRONS, Nov. 30, 1981, at 9.

20. *See Roundtable: Strategies of Takeover Attack and Defense*, MERG. & ACQUIS., Winter, 1985, at 24; *Dealmakers Cut Failure Rate*, MERG. & ACQUIS., Spring, 1985, at 23.

21. Freund, *supra* note 4, at 22.

22. *Id.*

23. Empirical evidence suggests that on the day of official disclosure, the target's stock rises to a price that represents the price to be paid in connection with the merger, discounted by the possibility that the deal will fall through. *See* Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51, 66 (1983). Only five percent of the market's reaction to the news occurs after the day of disclosure. *See* Keown & Pinkerton, *supra* note 9, at 866.

brokers and institutional investors enjoy relatively easy access to management and information.[24] This access may create enormous difficulties if management wants to keep the negotiations secret and at the same time avoid selective disclosure.[25]

Most large public corporations have well-developed analyst relations programs that promote the company's stock by providing information on the management quality and the prospects of the company.[26] Likewise, financial analysts and brokers are compensated in part for the contacts they are able to maintain with corporate executives.[27] The SEC and the exchanges advise publicly traded corporations to maintain an "open door" policy with respect to analyst relations.[28] The rationale is that analysts will receive and study small bits of non-material information from the executives, and will be able to make observations about investment value.[29] This type of analysis has a positive effect on the efficiency of the market. However, disclosure of merger negotiations is not what the SEC has in mind when it encourages exchange of information. Unfortunately, effective disclosure to such experts is seldom avoidable. For the analyst who is accustomed to candor from executives, anything the executive says will often result in effective disclosure. The extent of disclosure of confidential information in such cases is a function of the skill and persistence of the analyst and the public relations finesse of the executive.[30]

Shareholders, primarily of the target corporation, are caught in the middle of this situation. Their interests are largely adverse to management interests until public disclosure is made. News of a possible merger is

24. *See* Anders, *Here's How Stock-Market Experts Decide Which Rumors to Act On*, Wall St. J., Feb. 4, 1986, at 29. *But see* Boland, *SEC Chimera: Mom, Pop and Arb Made Equal*, Wall St. J., Feb. 19, 1986, at 30 (equal access to information an unattainable and undesirable regulatory goal); O'Donnell, *Silence Was Golden*, FORBES, Oct. 8, 1984, at 41 ("They [small investors] have made a lot of money as it is, so they're really not losing. They're just not getting that final little shot.") (quoting an anonymous investment analyst).

25. *See* 3B H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.17, at 9-66 (1984) (policy of "ad hoc disclosures" is "fraught with peril"); Williams, *Corporate Publicity*, in FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 391, 407 (1973).

26. *See* Bean, *Dealing With the Financial Community and Changing Markets*, REPRESENTING PUBLICLY TRADED CORPORATIONS (PLI), 73, 82 (1984). *See, e.g.*, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

27. Solomon & Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 FORDHAM L. REV. 505, 516–17 (1975).

28. Investors Management Co., Exchange Act Release No. 9267, [1971] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,521 (July 29, 1971); New York Stock Exchange Company Manual § 202.02, *reprinted in* 3 Fed. Sec. L. Rep. (CCH) ¶ 23,513, at 17,211 [hereinafter NYSE Company Manual]; American Stock Exchange Company Guide § 402, *reprinted in* 3 Fed. Sec. L. Rep. (CCH) ¶ 23,124B [hereinafter AMEX Company Guide].

29. *See* Investors Management Co., Exchange Act Release No. 9267, [1971] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,521 (July 29, 1971).

30. *See* SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 9 (2d Cir. 1977).

enormously important news to shareholders, because of the potential for earning a return substantially above the market rate.[31]

So long as the news of the merger negotiations remains a secret and no insiders trade on the information, the average shareholder is not unusually disadvantaged. However, once unusual increases in price and volume begin, it is probable that persons with superior information are purchasing in large volumes from existing shareholders who have not been informed.

C. *Rule 10b-5*

Rule 10b-5 provides that it is unlawful for a person to make an untrue statement or misleading statement of material fact, or to omit a material fact in connection with the purchase or sale of securities.[32] The rule requires disclosure of material information by corporate management only if there is a duty to disclose.[33] Management has a duty to correct misleading statements for which it is responsible.[34] A corporation has a duty to disclose all material facts before it trades its own stock.[35] Absent such a duty, disclosure of material developments is within the discretion of corporate management. Delays in disclosure are governed by the principle that no duty to disclose arises where management does not have confidence in the accuracy of the facts in question, or where management has a valid corporate purpose for delaying disclosure.[36] Only a corporation's "undue

31. One way to evaluate the impact of merger negotiations is to examine the daily stock prices of target firms during the period of time surrounding the announcement or the conclusion of the transaction. Abnormal returns represent the difference between actual returns on the stock and the expected returns calculated by means of a market index. At least thirteen studies have identified and analyzed abnormal returns on target firm stock prices for a specified period before and after announcement. Their results are compiled in Jensen & Ruback, *supra* note 17. Depending on the period of calculation, the average abnormal returns on mergers range from 13.3% to 33.96%. The studies analyzed market responses to both mergers and tender offers. *Id.* at 12–13.

32. 17 C.F.R. § 240.10b-5.

33. *See* Levinson v. Basic, Inc., 786 F.2d 741, 746 (6th Cir. 1986).

34. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).

35. Most commentators agree that no court has yet clearly imposed an affirmative duty to disclose all material information. Voluminous commentary has been generated on the issue of whether an affirmative duty to disclose *should* be imposed. *See, e.g.*, Exchange Act Release No. 8995, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915 (Oct. 15, 1970); 5A A. JACOBS, THE IMPACT OF RULE 10b-5 § 88.04 (1979); Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979); Talesnick, *Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?*, 49 DEN. L.J. 369 (1973); Comment, *Disclosure of Material Inside Information: An Affirmative Corporate Duty?*, 1980 ARIZ. ST. L.J. 795.

36. *See* Financial Indus. Fund v. McDonnell Douglas Corp., 474 F.2d 514, 518–19 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n. 12 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Astor v. Texas Gulf Sulphur, 306 F. Supp. 1333 (S.D.N.Y. 1969).

delay in bad faith" might trigger liability for failure to disclose.[37]

Rule 10b-5 imposes a duty to disclose only material facts. The Supreme Court has defined a fact as material if "there is a substantial likelihood that the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[38]

Generally, materiality is an issue of fact.[39] In theory, the materiality issue is only resolved as a matter of law "if a fact is so obviously important [or unimportant] to the investor that reasonable minds could not differ."[40] If the event is uncertain to occur, the probability that it will occur is balanced against the potential impact the event will have on the company and its shareholders.[41]

D. *Current Controversy Over Merger Disclosure*

A recent line of cases attempts to balance the interests of corporate management in secrecy and the interests of shareholders in knowing about the presence of merger negotiations. The cases come to different conclusions on the following three issues: (1) whether and when merger negotiations are material developments; (2) when is there a duty to disclose merger negotiations; and (3) what constitutes a misleading statement in connection with the disclosure of merger negotiations and how can misleading statements be avoided.

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37. *Financial Indus. Fund*, 474 F.2d at 519. Furthermore, no court has held a corporation which has been silent liable for "undue delay" when it did not trade.

38. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).

39. *Id.* at 450.

40. *Id.* (quoting Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970)).

41. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). *See, e.g.* Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 880 (2d Cir. 1972) (not error to instruct the jury that defendant had to have "material information as to a reasonably probable merger").

Some courts have incorporated the effect the information may have on the value of the stock into the materiality analysis. They suggest that the traditional torts formulation encompasses this idea. *See, e.g.*, List v. Fashion Park, Inc., 227 F. Supp. 906 (S.D.N.Y. 1964), *aff'd*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

Although most courts insist that the materiality standard is an objective one, TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976), some commentators contend that a subjective element of materiality sometimes comes into play, especially when there are identified insiders who are trading. 5 A. JACOBS, *supra* note 35, § 61.02[c] (The subjective test measures materiality according to "the actions of persons possessing the fact in question."). Indications of when information becomes material include the point at which insiders begin trading, and the vehemence with which management opposes disclosure. *Id.*; 3B BLOOMENTHAL, *supra* note 25, § 9.22(2)(f). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). *See generally* Hewitt, *Developing Concepts of Materiality and Disclosure*, 32 BUS. LAW. 887 (1977).

1. Greenfield v. Heublein, Inc.*: Preliminary Merger Negotiations Are Immaterial as a Matter of Law*

The controversy over the materiality of merger negotiations stems from the Third Circuit's holding in *Greenfield v. Heublein, Inc.*[42] In *Greenfield,* Heublein Corporation began negotiations with Reynolds Corporation to avert a hostile takeover by another company.[43] During the negotiations, unusual market activity developed.[44] A New York Stock Exchange (NYSE) official called Heublein to determine the source of the activity.[45] A Heublein representative responded with a statement that management was aware of no corporate development that would explain the unusual activity.[46]

The Third Circuit held that preliminary merger negotiations are immaterial as a matter of law.[47] The court reasoned that because preliminary merger negotiations are tentative, disclosure of such negotiations tends to mislead shareholders.[48] Once agreement in principle is reached, the prob-

42. 742 F.2d 751 (3d Cir. 1984), *cert. denied,* 105 S. Ct. 1189 (1985).

43. *Greenfield,* 742 F.2d at 753.

44. *Id.* at 754. Heublein stock rose three and a quarter points. It was not clear that the increase was the product of a leak about the negotiations. On the day the unusual market activity developed, General Cinema, the party threatening the hostile takeover, threatened to sell one of its principal assets. *Id.* The unusual market activity may have been in response to the belief that General Cinema was finally preparing to fund a takeover.

45. *Id.*

46. *Id.* The plaintiff, a Heublein shareholder who had been observing the developments closely, interpreted the statement as an indication that the price of the stock had peaked, and issued a sell order. *Id.* The day after Greenfield's stock was sold, trading in Heublein stock was suspended and the agreement was announced. *Id.* at 755. The plaintiff shareholder sued, alleging that Heublein had withheld information about the merger negotiations in violation of Rule 10b-5. *Id.* The district court dismissed on the defendant's motion for summary judgment, Greenfield v. Heublein, Inc., 575 F. Supp. 1325 (E.D. Pa. 1983), and the Third Circuit affirmed. *Greenfield,* 742 F.2d at 753.

47. *Id.* at 756.

48. The *Greenfield* court relied in large part for its reasoning on an earlier Third Circuit decision, Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982). In *Staffin,* Bluebird Corporation made a tender offer for its own shares without disclosing that it was considering a merger. *Id.* at 1200–01. The court reasoned that merger negotiations are immaterial because disclosure tends to mislead investors and does existing shareholders more harm than good. *Id.* at 1206. The court relied on testimony and material from the major stock exchanges explaining the impact of negotiations in the related area of tender offers, and the need for secrecy. The court explained that early disclosure affects the ability of the parties to conclude the transaction. Disclosure induces the price to rise rapidly toward the expected tender price. Once this occurs, the buyer may not be able to offer a sufficient premium over the inflated price to induce shareholders to tender their shares. *Id.*

Disclosure also induces investors to buy stock at an inflated price, the court said, without considering the possibility of success. If the transaction collapses, those who bought the stock at the elevated price have incurred a loss. The rest of the stockholders have lost the opportunity to sell at a premium price. *Id.* at 1207.

Third, the corporation may not be able to make an adequate statement about the negotiations because if they are preliminary, the facts are in a constant state of flux. *Id.* at 1206–07. If, on the other hand, the negotiations are not disclosed, shareholders still benefit from a premium price if the transaction is concluded. If it falls through, no one is worse off. *Id.* at 1207.

lem of misleading shareholders "yields" to the shareholders' right to know about the corporation's plans.[49]

The *Greenfield* court discussed disclosure in terms of "agreement in principle,"[50] concluding that agreement must exist on the fundamental terms of the merger—price and structure—before there is any duty to disclose.[51] The court reasoned that management needs definite and usable standards for determining when it must disclose such negotiations.[52] Otherwise, it would disclose all the details of merger negotiations prematurely in order to avoid liability, resulting in investor confusion and disruption of the market.[53] According to the court, the "no corporate development" statement was not misleading, because Heublein did not omit any material facts from the statement.[54] Moreover, Heublein did not have indications that those knowledgeable about the negotiations had leaked them to outsiders.[55]

A sharp dissent criticized the majority's emphasis on management needs at the expense of investor protection.[56] Judge Higginbotham insisted that when a corporation voluntarily issues a statement calculated to influence the investing public, it must insure that the statement is not false or misleading.[57] He found the no corporate development statement false because management clearly knew of information that could have accounted for the unusual market activity.[58] He emphasized that nothing compels the corporation to make any statement about the negotiations—not even the call from the NYSE representative.[59]

2. *The SEC's Position*

The SEC has focused on the question of materiality of merger negotiations. It maintains the position that materiality cannot be determined as a matter of law in merger negotiation cases. The SEC argues that the materiality of corporate developments should be and has traditionally been decided on a case by case basis. Merger negotiations are often material long before agreement on price and structure are reached.[60] According to

49. *Greenfield*, 742 F.2d at 756.
50. *Id.*
51. *Id.*
52. *Id.* at 757.
53. *Id.*
54. *Id.* at 759. *See infra* note 67.
55. *Greenfield*, 742 F.2d at 759.
56. *Id.* at 761.
57. *Id.* at 760–61.
58. *Id.* at 761. He found unacceptable the result that "Heublein is free to assume that its confidences are maintained and accorded complete secrecy, even in the face of otherwise inexplicable investor activity." *Id.* at 763.
59. *Id.* at 761.
60. SEC Amicus Brief, *supra* note 7, at 5–6.

the SEC, even though there is no duty to disclose material merger negotiations, the corporation has a duty not to make misleading statements about negotiations once they become important to a reasonable shareholder.

The SEC's position is that a "no corporate development" statement is misleading. Although a "no comment" response would be acceptable to the SEC, the negotiations should be disclosed if management chooses to make a statement.[61] The SEC has announced its intent to take enforcement action against companies that issue no corporate development statements during preliminary merger negotiations.[62]

3. Levinson v. Basic, Inc.

The SEC's premise has been accepted in part by the Sixth Circuit in *Levinson v. Basic, Inc.*[63] In that case, Basic's management issued four no corporate development statements in response to unusual market activity over a period of a year and a half during which it negotiated an ultimately successful merger.[64] The court held that a no corporate development statement is misleading if made during merger negotiations.[65] The court rejected *Greenfield's* narrow reading of the no corporate development statement. Under *Greenfield,* the no corporate development statement would be misleading only if management had specific facts to indicate that the information had been leaked. It was more reasonable, the court said, to interpret the statement broadly to mean the absence of any significant developments.[66]

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61. *In re* Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595–96 (July 8, 1985).

62. *Id.* at 87,592. As in the *Greenfield* case, the two companies were involved in preliminary merger negotiations when unusual market activity developed. Nestle had stipulated that if the talks were publicized, it would discontinue them. *Id.* at 87,593. The Carnation official who responded to the market representative, first with a no corporate development statement, and later with a more detailed statement denying knowledge of negotiations on behalf of Carnation, was actually unaware of the negotiations. *Id.* at 87,594. The shares of Carnation stock appreciated 40 percent from the time the negotiations began until public disclosure. O'Donnell, *Silence Was Golden,* FORBES, Oct. 8, 1984, at 41.

In connection with a petition for rehearing of a Seventh Circuit case, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985), *cert. denied,* 106 S. Ct. 797 (1986), the SEC also submitted an amicus brief asking the court to delete dictum stating that merger negotiations between publicly held companies were immaterial until agreement was reached on price and structure. SEC Amicus Brief, *supra* note 7, at 3. The Seventh Circuit subsequently declined to rehear the case, but did modify the opinion. The amended opinion adopted a neutral posture toward *Greenfield,* and acknowledged the conflict in the law. *Michaels,* 767 F.2d at 1187. The court stated explicitly that it did not decide the issue of whether merger negotiations between publicly held corporations are material before the parties have agreed on price and structure. *Id.*

63. 786 F.2d 741 (6th Cir. 1986).

64. *Levinson,* 786 F.2d at 744–45.

65. *Id.* at 747.

66. *Id.* at 748.

The court held that merger negotiations become material by virtue of the corporation having made a statement about the negotiations. The reasonable investor, the court said, having received the no corporate development statement, would think the news of preliminary merger negotiations an important fact in making an investment decision.[67]

II. ANALYSIS

The courts are not giving adequate weight to the protection of investors, particularly those who sell their stock during merger negotiations. The potential for abuse of information is often overlooked. Protection should be given to investors by imposing more stringent disclosure requirements on management. Management, however, needs predictable rules that enable it to know when sensitive events must be disclosed. Management cannot simply be told to disclose the presence of merger plans when they become important to the reasonable investor. The courts have the ability and the responsibility to formulate some clear disclosure rules that provide incentives for avoiding misleading or selective disclosure of such information, and to provide for public announcement when selective disclosure can no longer be avoided.

A. *Materiality of Merger Negotiations*

As judged by traditional standards, many preliminary merger negotiations are important to the reasonable investor. Courts continue, however, to rely on fictions like immateriality to justify their policy decisions.[68] This

67. *Id.* The court did not squarely reach the issue of whether merger negotiations are immaterial as a matter of law absent any disclosure. *Id.* at 748–49.

68. Merger negotiations are held immaterial as a matter of law on policy grounds; they are immaterial because they have too dramatic an effect on the market and on shareholders. First, the courts reason that early disclosure will often drive the price of the target corporation's stock up so far that the acquiring corporation will not be able to afford the purchase. Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982). (Another possibility, not mentioned by the courts, is that the acquiring corporation will simply pay the higher price. The price increase may impose a corresponding loss on shareholders of the acquiring corporation. Consequently, overall shareholder wealth may stay the same or decrease.).

Second, the negotiating parties cannot make disclosure of preliminary merger negotiations without misleading shareholders. *Id.* at 1206–07. *See* Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied,* 105 S. Ct. 1189 (1985); Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983). It is important to remember that *Staffin* was a tender offer case. It stated a claim under Rule 10b-5 and under § 14(e). The court placed explicit reliance on several cases which held that facts relating to possible competing bids are immaterial and need not be disclosed until a firm offer has been made. *See* Missouri Portland Cement Co. v. H. K. Porter Co., 535 F.2d 388, 398 (8th Cir. 1976); Berman v. Gerber Prods., 454 F. Supp. 1310 (W.D. Mich. 1978); Scott v. Multi-Amp Corp., 386 F. Supp. 44, 65 (D.N.J. 1974). *See also* Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075 (5th Cir. 1970) (acquiring reliance should be discontinued, since the result may be to allow management to make public misstatements about corporate developments.

The materiality of merger plans at any given stage in the development of the negotiations is extremely variable.[69] Materiality will depend, among other things, on the size of the corporations involved, the size of the potential premium, the attractiveness and potential of the takeover target, and the prospects for successful completion. If the target corporation is an attractive prospect, merger plans may become material when they are conceived. On the other hand, if the parties are small corporations and the prospects for success are unlikely, the negotiations may not be material until after agreement is reached.

B. *Misstatements—Problems of Corporate Publicity*

The *Greenfield* dissent and the SEC assert that corporate silence is the solution to the problem of misleading statements. Accordingly, it is argued that the corporation can simply refuse to answer any questions it receives from analysts, stock market officials, or stockholders.[70] This approach ignores the realities of disclosure of an event as volatile as merger negotiations. In many situations management will not have the option of remaining silent. Instead, a rumor will leak out, despite precautions, and management will be asked to confirm it.

1. *The "No Corporate Development" Statement*

The no corporate development statement was traditionally the rote response to any inquiries about possible negotiations. Analysts conversant in the language of rote responses often view such statements with skepticism.[71]

The *Levinson* court correctly reasoned that a no corporate development statement calculated to influence the investing public should be interpreted

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corporation's tentative plan to merge target after acquisition immaterial); W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 10.05, at 394 n.17.

To the extent that cases involving preliminary merger negotiations rely on these cases, their reliance is misplaced. The provisions in the Williams Act, Pub. L. No. 90–439, 82 Stat. 454 (1968), were designed to alleviate the abuses associated with disclosure of tender offers. *See* W. PAINTER, *supra*, § 10.01. For preliminary merger negotiations, those problems still exist.

69. See 5A JACOBS, *supra* note 35, § 61.04[c][ii] for positions of the federal circuits on how probable a merger must be before negotiations become material.

70. *Greenfield*, 742 F.2d at 763; SEC Amicus Brief, *supra* note 7, at 14.

71. During the Carnation merger negotiations, for example, a number of investment analysts indicated that they did not interpret the Carnation denial literally. O'Donnell, *Silence Was Golden*, FORBES, Oct. 8, 1984, at 41.

according to what it would mean to the reasonable investor.[72] A reasonable investor would rarely interpret the statement to mean that management knows of no leaks of admittedly significant corporate developments that have influenced the market price. The reasonable investor would instead be led to believe that there *were* no developments, confidential or otherwise, that would have influenced the market price.[73]

2. *An Affirmative Disclosure Rule*

Commentators have repeatedly called for the use of quantifiable standards to define materiality.[74] The SEC possesses the power to promulgate a rule designating a point at which merger negotiations must be disclosed. A merger disclosure rule would not involve quantitative standards, but would instead be triggered by an event common to the negotiating process of all mergers. Possibilities include disclosure when there is an "intent to merge,"[75] when a resolution to seek a merger has been adopted,[76] when an investment banker has been contacted, or when negotiations commence.[77]

At least two advantages would accrue if an affirmative disclosure rule were adopted. The investor would be protected against the effects of widespread trading on inside information that occurs before disclosure in many cases. Management would also be given a predictable disclosure standard.

72. Contrast this with the convoluted reasoning of the *Greenfield* decision. The court begins with the proposition that merger negotiations are immaterial as a matter of law. This fiction is demonstrably false, as empirical studies have proven the impact of information about merger negotiations on investor behavior. *See supra* notes 9–17, 30 and accompanying text. The court then reasons that a statement which omits a fact labelled immaterial by the court cannot be misleading.

73. The *Greenfield* court appears to have read the no corporate development statement according to the state of facts known to management at the time the statement was made. In the *Texas Gulf Sulphur* proceeding, the district court used this standard and was reversed on those grounds. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862–63 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). The court of appeals for the second circuit stressed that the adequacy of press releases was to be determined from the investor's point of view. *Id.*

74. *See* Blackstone, *A Roadmap for Disclosure vs. a Blueprint for Fraud*, 26 UCLA L. REV. 74, 85 (1978) (suggesting that the SEC establish specific or quantitative guidelines for disclosure of certain events); Jennings, Reckers & Kneer, *A Source of Insecurity: A Discussion and an Empirical Examination of Standards of Disclosure and Levels of Materiality in Financial Statements*, 10 J. CORP. L. 639 (1985); *see also* 3B H. BLOOMENTHAL, *supra* note 25, § 9.22[2][a].

75. This disclosure standard was urged by the plaintiff in *Greenfield*, 742 F.2d at 757.

76. *See, e.g.*, Reiss v. Pan Am. World Airways, 711 F.2d 11, 13 (2d Cir. 1983) (resolution by board to seek a merger not material).

77. Blackstone, *supra* note 74, at 85 (disclosure should be required at the commencement of negotiations, when the terms are set, and when the agreement is concluded).

3. *Problems with an Affirmative Disclosure Rule*

Undoubtedly, there is difficulty in framing a sufficiently general disclosure rule that would operate across the many factual circumstances that occur during merger negotiations. A predictable standard necessarily involves a certain amount of arbitrary line drawing. If a rule were to be predicated on an event that occurred during the negotiations, disclosure of preliminary merger plans would be required. Yet, under a traditional analysis, many of those plans would not be material until later in the negotiating process. In other cases, circumstances might be such that disclosure would not be required even though the plans had been material for some time. Furthermore, in circumstances where negotiations were especially significant, management would still be faced with the problem of avoiding misleading statements, unless it were allowed to tell all who inquired that there were no developments. Such a solution would present a reprise of *Greenfield.*

An affirmative disclosure rule would produce problems associated with market impact. *Greenfield* accepts the premise that early disclosure impedes and sometimes prevents the consummation of mergers.[78] Early disclosure may force the buyer to increase the premium price solely to compensate for the increased share price that disclosure produces.[79] This argument presents a worst case scenario in which investors respond to disclosure with a frenzy of speculative trading. In turn, the market price is forced above what the buyer can afford. Any incentive shareholders have to approve the deal is effectively destroyed.

The notion that early disclosure prevents mergers has never been empirically confirmed. Although empirical evidence measuring how disclosure at agreement in principle affects the market exists,[80] no similar data demonstrate how disclosure before agreement in principle affects the market. Specifically, no study shows whether the price does in fact tend to rise systematically above the expected price the acquiring corporation is willing to pay. Courts have relied solely on assertions of the business community and representatives of the stock market.[81]

One might hypothesize that the market's ability to respond accurately to disclosure should depend on how much verifiable information the parties are able to make public. Two situations demonstrate the market's possible

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78. Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied,* 105 S. Ct. 1189 (1985); Staffin v. Greenberg, 672 F.2d 1207–08 (3d Cir. 1982).

79. *Greenfield,* 742 F.2d at 756; *Staffin,* 672 F.2d at 1207–08.

80. *See supra* notes 12–13 and accompanying text.

81. *See Staffin,* 672 F.2d at 1206 (quoting *Transcript, Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency,* 90th Cong., 1st Sess. 72 (1967) (statement of Mr. Calvin on behalf of the New York Stock Exchange, Inc.)).

reaction. First, if the negotiations have progressed such that both the negotiating parties can be identified, the market may be capable of assessing the expected range of prices. If the market is operating efficiently, the share price would be discounted by the possibility that the deal will not occur.[82] However, the prediction of the potential premium to be paid is by no means an exact science. It is not clear that the market can evaluate the price with enough certainty to support this hypothesis.[83]

On the other hand, if the target had not yet found a buyer, investors would have insufficient information with which to assess the transaction and the probable price the target would bring. Price increases fueled by optimistic speculation would be much more likely to rise above the price any potential buyer is willing to pay.[84]

The most significant problem posed by automatic disclosure before agreement in principle is that every target corporation would be put up for auction at the time of disclosure. This approach imposes serious limits on management discretion. Despite the prevalence of rumors and unusual market activity, some corporations successfully maintain silence and prevent leaks until public announcement.[85] Management ought to be able to maintain silence, even though that silence may be partly dependent on good fortune in receiving no inquiries.[86] A workable disclosure rule would not be capable of making that distinction. To the extent that success is attributable to a careful disclosure policy, a corporation should not be penalized.

4. *No Comment*

A "no comment" response to an inquiry about the existence of negotiations is not entirely satisfactory, but it does have certain advantages. The

82. *See* Asquith, *supra* note 23, at 66.

83. *See* Penn, *Premiums—What Do They Really Measure?*, MERG. & ACQUIS., Fall, 1981, at 32 ("In the end, the premium you pay depends on what *you believe* you can do with the company or assets versus what *others believe* they can do. As such, it is a very subjective matter.") (emphasis original).

84. Management is understandably more concerned with problems that competing bids bring about if disclosure is made when no binding agreement has been reached than it is with aggregate economic efficiency. *See, e.g.*, J. FREUND, ANATOMY OF A MERGER 68 (1975); *Disclosure Rule Is Debated*, MERG. & ACQUIS., Jan./Feb. 1986, at 21. *See also In re* Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,593 (July 8, 1985) (acquiring corporation stipulated that it would terminate negotiations if public disclosure was made). One may question, however, whether this is an appropriate rationale for secrecy. Although competing bids create problems for individual corporate practitioners, they tend to maximize shareholder welfare.

85. *See* Merjos, *Who Knew What When?*, BARRON'S, July 19, 1982, at 32 (some pending deals are well kept secrets).

86. A survey of corporate attorneys indicates that the response to the SEC's position in *Carnation* has been to institute more careful disclosure procedures, and to route all inquiries through a single spokesperson who routinely indicates that the company has a policy of not commenting on rumors. *Disclosure Rule Is Debated*, MERG. & ACQUIS., Jan./Feb. 1986, at 21. These are positive developments which may succeed in reducing the incidence of selective disclosure.

SEC and the courts imply that no comment is the functional equivalent of silence.[87] This view may be incorrect when there are rumors of pending negotiations. In these instances, no comment effectively discloses that someone is negotiating.[88] It may result in a misleading statement if the negotiations have progressed far enough. It may also be unacceptable if the person inquiring is a representative of the exchange on which the party's stock is traded.[89]

A no comment policy, however, is the best way to avoid misleading statements about the presence of merger negotiations. When coupled with a rule that requires disclosure if the market responds, the disclosure provisions may operate to minimize the impact of selective disclosure and provide incentives for prevention of leaks.

C. *Duty to Disclose If the Corporation Has Been Silent*

As discussed above, if a corporation has successfully maintained silence during the course of negotiations, it may remain silent. This section argues that some affirmative duties to disclose merger negotiations are necessary for the protection of investors. In most instances, the timing of disclosure should be a matter of balancing the interests of management in silence, and the interests of shareholders in curbing fraud.

1. *Duty to Disclose When the Corporation Is Trading Its Own Stock*

One consequence of holding that merger negotiations are immaterial as a matter of law is that a corporation has no duty to disclose even if it trades its own stock.[90] This problem may arise when a corporate development, unrelated to the merger negotiations, necessitates a sale or purchase of the corporation's own stock. For example, in *Reiss v. Pan American World Airways*,[91] the board of directors authorized a call of convertible debentures at the same time as it passed a resolution to acquire National

87. *See In re* Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 n.6 (July 8, 1985); Greenfield v. Heublein, Inc., 742 F.2d 751, 763 (3d Cir. 1984) (Higginbotham, J., dissenting), *cert. denied*, 105 S. Ct. 1189 (1985).

88. *See Materiality of Merger Negotiations, SEC Rules Discussed at ABA Meeting*, 17 Sec. Reg. & L. Rep. (BNA) 2076, 2077 (1985) [hereinafter *Materiality of Merger Negotiations*]; Anders, *supra* note 24, at 29.

89. *Materiality of Merger Negotiations*, *supra* note 88, at 2077. The NYSE Listing Agreement requires the listed company to provide any information to the exchange that "it may reasonably require." NYSE Company Manual, *supra* note 28, § 202.04. *See* AMEX Company Guide, *supra* note 28, § 402; *see also* SEC v. Geon Indus., 531 F.2d 39, 44–45 (2d Cir. 1976).

90. SEC Amicus Brief, *supra* note 7, at 8; Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 783–84 (1985).

91. 711 F.2d 11 (2d Cir. 1983).

Airlines.[92] Management announced the call publicly, but did not disclose the resolution. The court reasoned that disclosure of the merger negotiations did not serve the purposes of the securities laws because negotiations are "inherently fluid" and the outcome is uncertain.[93]

Similarly, in *Staffin v. Greenberg,*[94] Bluebird Corporation made a tender offer for its own shares without disclosing that it was considering a merger. The court reasoned that merger negotiations are immaterial, because disclosure tends to mislead investors and to harm existing stockholders more than it benefits them. This is because disclosure tends to drive the price up during the negotiations and imperil the transaction.[95]

Even if the policy reasons articulated by the courts are valid, they do not justify a holding that negotiations are immaterial, when the result of such a holding is to allow the corporation to trade without disclosure of material information to its own shareholders. The *Greenfield* line of cases balances the corporation's interests against the investors' interests, concluding that the corporation has important business reasons for nondisclosure that outweigh the investors' need to know before agreement in principle.[96] Admittedly, the corporation has a valid interest in preserving the secrecy of negotiations so that the transaction can be concluded with minimal interference.[97] Shareholders, however, are entitled to full disclosure and fair dealing by the corporation involved, no matter what corporate developments are pending. The primary policy justification for Rule 10b-5 is to protect investors by preventing unfairness and fraudulent transactions.[98] Consequently, the courts misconceive the policy behind the rule when they apply a balancing test to trading by the corporation in its own shares.

Courts use different standards of materiality for disclosure of merger negotiations in cases involving identified insider trading.[99] In *SEC v. Geon, Inc.*,[100] the Second Circuit reasoned that a valid business purpose exists for conducting negotiations in secret, but does not justify trading on inside information.[101] "Materiality has a different aspect when inside information

92. *Reiss,* 711 F.2d at 14.

93. *Id.*

94. 672 F.2d 1196 (3d Cir. 1982).

95. *Staffin,* 672 F.2d at 1206–07.

96. Michaels v. Michaels, 767 F.2d 1185, 1196 (7th Cir. 1985), *cert. denied,* 106 S. Ct. 797 (1986); Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied,* 105 S. Ct. 1189 (1985); *Reiss,* 711 F.2d at 14; *Staffin,* 672 F.2d at 1206.

97. Underlying the courts' reasoning on this issue may be the practical perception that a corporation cannot suspend all its other activities requiring disclosure while it negotiates the merger, and should not be penalized for complying with its other disclosure obligations.

98. 5 A. Jacobs, *supra* note 35, § 6.06.

99. *Id.* § 61.02.

100. 531 F.2d 39 (2d Cir. 1974).

101. *Geon,* 531 F.2d at 48.

is disclosed to a favored few."[102] No court has ever held that merger negotiations are immaterial when an individual defendant is accused of insider trading; such a result would be extremely unlikely. Any principled distinctions between insider and non-insider trading cases dwindle when the corporation is trading.[103] In both *Reiss* and *Staffin,* the corporation achieved important objectives, each with the help of a group of shareholders who disposed of their interests to the corporation without being told that a merger was pending.[104] The corporation's trading without disclosure in such circumstances is no more defensible than insider trading. It should not be condoned by the courts.

2. *Duty to Disclose at Agreement in Principle*

Although judicial use of the agreement in principle disclosure requirement is of relatively recent origin, it has been the recommended disclosure standard in the business community for some time.[105] Agreement in principle is a perfectly satisfactory disclosure standard if absolute silence has been maintained. Delay of disclosure protects the business venture and the stability of the market, while minimizing unfairness to investors. There is some indication, however, that the predictability of the agreement in principle standard may be eroding.

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102. *Id.* The SEC relies heavily on insider trading cases in its amicus brief. *See, e.g.,* SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); SEC v. Gaspar, [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985). It asserts that the *Greenfield* holding will allow insiders to trade freely on news of negotiations. Although this proposition is a logical extension of *Greenfield,* it is unlikely to occur, even if the courts continue to adhere to the *Greenfield* reasoning when the defendant is not trading. *See, e.g.,* Levinson v. Basic, Inc., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,801, at 90,013, 90,015 n. 11 ("This is not a case involving insider trading . . . [so] insider trading cases are [not] applicable or controlling."), *rev'd,* 786 F.2d 741 (6th Cir. 1986).

103. The only identifiable difference is that the trading is done by an entity, not an individual, so that no personal gain is attained.

104. In Schlanger v. Four-Phase Systems, 582 F. Supp. 128 (S.D.N.Y. 1984), the court distinguished *Reiss* and *Staffin* from *Greenfield* on the grounds that, inter alia, both involved failure to say anything about the merger plans when announcing the transactions in question, and that the announced transactions were unrelated to the merger. *Id.* at 133. The court failed to state why the factual distinctions were important. In the absence of trading, a corporation has no duty to disclose all conceivably material information when announcing a routine corporate event. *See* Williams, *supra* note 25, at 391. The fact that the corporation is trading gives new significance to the failure to disclose. The corporation should have a duty, no matter how inconvenient, to disclose nonpublic information that would be material to the decision of investors who tender their shares.

105. *See* J. FREUND, ANATOMY OF A MERGER 67 (1975); Bromberg, *Disclosure Programs for Publicly Held Companies—A Practical Guide,* 1970 DUKE L. J. 1139; Fleischer, *Corporate Disclosure/Insider Trading,* HARV. BUS. REV., Jan.-Feb. 1967, at 129; Flom & Atkins, *The Expanding Scope of SEC Disclosure Laws,* HARV. BUS. REV., July-Aug. 1974, at 109; Williams, *Corporate Publicity,* supra note 25, at 391.

Before agreement in principle, it is possible to restrict participation in and knowledge of the negotiations to a very small group.[106] After agreement in principle, it becomes difficult, if not impossible, to restrict disclosure of the merger plans to a small enough circle of persons to avoid trading on the undisclosed information.[107] Corporations may be implicated in insider trading scandals if they prolong the period of secrecy. Furthermore, it may not be desirable to restrict trading, as insiders often wish to buy shares at this point.[108]

Disclosure at agreement in principle facilitates an orderly and predictable market response to the news.[109] Investors can assess their prospects accordingly. In contrast, disclosure before the price and terms have been set may prompt rapid and entirely speculative price increases.

Only when agreement in principle is reached will the parties be able to disclose most of the information that is essential to an educated investment decision. Essential information includes not only the price and post-merger structure articulated in *Greenfield,*[110] but also the identities of both the parties, and other information bearing on the business logic of the transaction and the prospects of the merged entity.[111]

Staffin and *Greenfield* hold that once agreement in principle is reached there is an affirmative duty to disclose the negotiations, regardless of whether the corporation plans to trade its own stock or anticipates leaks;[112] thus they emphasize the need for flexible and specific standards for management.[113] This rule is distinguishable from the notion that merger negotiations are immaterial until agreement in principle. The issue of materiality need not be addressed until after it is determined that there is a duty to disclose material information.

Conceptually, an affirmative duty to disclose is inconsistent with well established interpretations of Rule 10b-5. Absent command by rule or statute, affirmative disclosure obligations under Rule 10b-5 are seldom

106. West, *Timely Disclosure: The View from 11 Wall Street,* 24 Sw. L.J. 241 (1970).

107. *Id.* at 243.

108. *Id.* at 245.

109. The market should reflect the value of the offer discounted by the possibility that the merger will not occur. *See* Asquith, *supra* note 23, at 80–82 (capital market evaluates uncertainty that the merger will occur).

110. Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied,* 105 S. Ct. 1189 (1985).

111. *Id.*

112. *See Greenfield,* 742 F.2d at 756; Staffin v. Greenberg, 672 F.2d 1196, 1207 (3d Cir. 1982).

113. *Greenfield,* 742 F.2d at 756.

imposed.[114] However, given the need for predictability in this area, such a rule is warranted.[115]

The timing of agreement in principle is no longer as predictable as it once was. Before the advent of the current round of hostile takeover activity, agreement in principle was normally a nonbinding agreement that specified the price, a description of the basic terms of the deal and the more important conditions of closing.[116] The transaction would then proceed at a comparatively leisurely pace until the closing.[117]

In many instances that scenario has changed drastically. The market's appetite for established companies has placed extreme pressure on the parties to negotiate in secret.[118] They usually aim for a binding agreement that covers all necessary points before disclosure is made.[119] The negotiations proceed much further, and much more quickly before disclosure than was previously the case. If the parties think that early disclosure is even a remote possibility, they tend to accelerate the negotiating process.[120]

The Texaco/Penzoil verdict has also raised doubts about the definition of agreement in principle. That decision made Penzoil's agreement in principle with Getty Oil presumptively binding, even though the agreement did not so specify.[121] That holding also places pressure on the parties to progress much further in the negotiating process before an announcement is made.[122] It will be necessary in the future for the disclosure standard to evolve along with the definition of agreement in principle.

3. *Duty to Disclose When Unusual Market Activity Occurs*

In recent years a great deal of emphasis has been placed on adjusting the operation of the securities laws to reflect current notions about the efficient capital market hypothesis.[123] Efficient capital market theory posits that all publicly available information about a corporation is immediately reflected

114. *See supra* note 33.

115. Delaying disclosure past agreement in principle may tempt a court to hold that the delay of disclosure was undue. *See supra* notes 35–36 and accompanying text.

116. J. FREUND, ANATOMY OF A MERGER 60–64 (1975).

117. *Id.*

118. Freund, *Mergers & Acquisitions*, Nat'l L.J., Nov. 11, 1985, at 13, col. 1.

119. *Id.* at 21.

120. *Id.*

121. *See* Riley, *Aberration'—Or Lesson in Contracts*, Nat'l L.J., Dec. 2, 1985, at 13, col. 1.

122. *See* Waldman, *Texaco Penzoil Case Makes Firms Careful About Merger Moves*, Wall St. J., Apr. 16, 1986, at 1, col. 1.

123. *See* Fischel, *Use of Modern Finance Theory in Securities Fraud Cases*, 38 BUS. LAW. 1 (1982); *see generally* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 62–139 (1979).

in the price of its stock.[124] A sudden rapid increase in price or volume without a public statement could indicate that a piece of nonpublic information had suddenly become available to certain sectors of the investing public.[125]

The courts have unaccountably refused to entertain any suggestion that this type of selective disclosure should trigger a public announcement by the corporation.[126] As in the *Greenfield* case, many courts allow corporations a presumption of confidentiality, even if there are material developments known to management that, if leaked, would produce price increases.[127] Unless management has affirmative proof that someone has leaked the information from inside the company, it may presume that the negotiations are a secret, despite the presence of unusual market activity.[128]

This presumption of secrecy parallels a related rule concerning correction or verification of rumors. The Second Circuit has held that a corporation has no legal obligation to correct or verify rumors not attributable to it.[129] This rule operates regardless of whether the rumor has affected the market price of the stock.

As applied to unusual market activity during merger negotiations, the plaintiff bears a heavy burden of proof to show that unusual market activity is attributable to the corporation. The plaintiff must show a breach of confidentiality by an insider and subsequent trading on the information substantial enough to produce unusual activity.[130] The plaintiff's burden is virtually impossible to meet, given the incentives of the corporation and of insiders to keep the negotiations a secret.

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124. *See* Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 375 (1984).

125. Keown & Pinkerton, *supra* note 9, at 856.

126. The only case that suggested unusual market activity as a trigger to disclosure was State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278, 292 (S.D.N.Y. 1980). The court of appeals did not reverse on the issue of whether unusual market activity was a factor, but held that disclosure was not required under the particular factual circumstances. State Teacher Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981). *See* Brown, *supra* note 90, at 781; 5A A. JACOBS, *supra* note 35, § 88.04.

127. Greenfield v. Heublein, Inc., 742 F.2d 751, 759, 763 (3d Cir. 1984) (Higginbotham, J., dissenting), *cert. denied*, 105 S. Ct. 1189 (1985); Zuckerman v. Harnischfeger Corp., 591 F. Supp. 112, 120 (S.D.N.Y. 1984). The SEC's position on this point is unclear. It first suggests that a corporation has a duty to correct or verify if it is aware that a rumor exists. Later, however, it asserts that correction is only required if the company is responsible for the leaks. SEC Amicus Brief, *supra* note 7, at 3 n.2.

128. *Greenfield*, 742 F.2d at 759; *Zuckerman*, 591 F. Supp. at 120.

129. State Teacher's Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1983); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969). *See also* Weintraub v. Texasgulf, 564 F. Supp. 1466, 1470 (S.D.N.Y. 1983) (no duty to investigate the source of the rumors).

130. *See* Sheffey, *Securities Law Responsibilities of Issuers to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem*, 57 NOTRE DAME L. REV. 755, 779 (1984).

It is not difficult to account for the courts' insistence on proof of corporate responsibility for rumors before a duty to disclose arises. A strongly ingrained notion exists that, at least with respect to the general disclosure obligations under Rule 10b-5, the corporation ought to be allowed to control the timing of disclosure to coincide with the best interests of the business, so long as it abstains from trading its own stock.[131] The rationale is that a corporation is subject to potential fraud liability for misleading statements every time it issues a statement. It should not be forced to disclose unless it is necessary to correct a previous mistake or error.[132]

The practical problems associated with correction of rumors are also a factor in the insistence on proof of responsibility for rumors. Commentators have argued that a corporation cannot practically discover and correct all the rumors about it. For a large corporation that generates large amounts of news, even correcting the rumors of which it is aware would be a serious undertaking. Often management is not in a position to know whether or not the information is correct.[133] A company might be susceptible to blackmail, especially in the context of a hostile takeover or competitive bidding, if the adversary could force premature disclosure of plans by creating a rumor about the price or terms of the current negotiations.[134]

At least with respect to undisclosed merger negotiations, these rationales are invalid. Most of the practical problems will not apply when a rumor of a development as important as merger negotiations is translated into unusual market activity. Publicly traded corporations can make a practice of monitoring the trading in their stock.[135] They are put on notice that the rumor exists. Likewise, rumors of merger negotiations do not involve facts that management has to investigate before it can make accurate disclosure.[136]

More importantly, once a rumor has generated unusual market activity, the timing of disclosure is already outside the corporation's control. Management has no good alternatives to disclosure when unusual market activity occurs. All that management achieves by withholding public disclosure is to slow the rise in price that occurs as the market assimilates the rumor. Nondisclosure merely delays the point at which the rapid

131. *See* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); Sheffey, *supra* note 130, at 778–79; Bauman, *supra* note 35, at 939.

132. SEC v. Texas Gulf Sulphur, 401 F.2d at 867 (Friendly, J., concurring).

133. Sheffey, *supra* note 130, at 775–76; 5A A. Jacobs, *supra* note 35, § 88.04[b]; Allen, *supra* note 35, at 496.

134. Sheffey, *supra* note 130, at 776.

135. *Id.*

136. *See id.*

increase occurs in response to public announcement, and lessens the business inconvenience associated with early disclosure.

From the point of view of investors and the market, requiring disclosure of merger negotiations when unusual market activity occurs would be a significant improvement. Disclosure is consonant with the very explicit rules of all the major exchanges.[137] The exchanges advise corporations to use the greatest care in insuring the secrecy of such negotiations. Present law, however, provides inadequate incentives to insure that negotiations stay secret.[138]

Disclosure when unusual market activity occurs is consistent with good corporate practice, and would impose no new burdens on corporations that generally seek to comply with the law.[139] Corporate practitioners advise that allowing unusual market activity to proceed, unexplained, causes damage to the company's reputation that outweighs the benefits of a short period of continued secrecy.[140]

Disclosure serves the underlying purposes of the securities laws. The market is protected against the prolonged effects of selective disclosure of material information. Disclosure provides a sorely needed disincentive against insider trading that is not dependent on SEC enforcement against identified individuals. Market integrity is promoted.[141] Finally, disclosure insures that investors who have no special sources of information and are less adept at following market signals have important information before them in an understandable form. Any other rule would imply that investors who fail to watch the Dow Jones tape do so at their own peril.[142]

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137. NYSE Company Manual, *supra* note 28, § 202.01. Once unusual market activity occurs, "frank and explicit announcement is clearly required. *Id.* § 202.03. American Stock Exchange requirements are even more explicit. They refer to the sensitivity of merger negotiations, AMEX Company Guide, *supra* note 28, § 402, and give specific instructions about how to deal with unusual market activity. *Id.*

138. The national exchanges' sanction for failure to disclose is a suspension of trading. *See* 3B H. BLOOMENTHAL, *supra* note 25, § 9.10[4]; Brown, *supra* note 90, at 778 n.149 (suggesting that the competitive pressures among the exchanges deter suspension of trading when it is actually necessary); *see also* Freund, *Selected Acquisition Problems Under Rules 10b-5 and 10b-6 and Under Section 16(b)*, in EIGHTH ANNUAL INST. ON SEC. REG., 233, 246–47 (1977).

A private right of action is probably not available for violation of the exchange rules that require disclosure when unusual market activity occurs. *See* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1983); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 358 U.S. 817 (1966); 3B H. BLOOMENTHAL, *supra* note 25, § 9.10[4]; *see also* Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980).

139. *See* Fleischer, *supra* note 105, at 134–35; West, *supra* note 106, at 245.

140. *See, e.g.*, J. FLOM, B. GARFINKLE & J. FREUND, DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS 231 (1967).

141. *See* Fleischer, Mundheim & Murphey, *supra* note 18, at 816.

142. *Cf.* Dennis, *supra* note 124 (unusual market activity should obviate the need for disclosure because investors can read the market signals); Friedman, *Efficient Market Theory and Rule 10b-5 Nondisclosure Claims: A Proposal for Reconciliation*, 47 MO. L. REV. 745 (1982).

Greenfield and *Staffin* assert that disclosure of negotiations is inherently misleading to investors.[143] The SEC argues in its brief for the Michaels case that if disclosure of negotiations has to be made, it can occur without being misleading.[144] The SEC's position is better reasoned. Effective truthful disclosure need not contain play-by-play descriptions of the negotiations. The fact that the parties are negotiating is a verifiable piece of information. It can be disclosed without misleading, so long as the corporation emphasizes that the outcome is uncertain and cannot be predicted.[145] If management makes it clear that any investments during the negotiations would be highly speculative, existing shareholders would be provided with information consistent with the disclosure philosophy of Rule 10b-5.

The argument that disclosure should not be required fails to take into account the empirical evidence summarized above, which indicates that any presumption that confidentiality has been maintained is, in most instances, thoroughly unsupported by the facts.[146] Corporate management may presume a lack of confidentiality beginning about two weeks before the time that agreement in principle is disclosed.

III. CONCLUSION

The recent treatment of disclosure of merger negotiations under Rule 10b-5 shows an increasing willingness by the courts to compromise the protection of investors in favor of management convenience, by holding preliminary merger negotiations immaterial as a matter of law. The results are unfortunate. Stock markets continue to labor under the effect of unexplained increases in price. Widespread trading on inside information continues unabated until agreement occurs.

The courts should respond to the problem of leaks of information by creating some affirmative disclosure obligations applicable to corporations which are involved in merger negotiations. Negotiating companies should

143. Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985); Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982).

144. *See* SEC Amicus Brief, *supra* note 7, at 7.

145. *Id.* The SEC refers to Schedule 14D-9, at 17 C.F.R. § 240.14d-101 (1985), relating to tender offers as a guideline for disclosure of necessary information. Schedule 14D-9 requires disclosure by a target corporation of negotiations being undertaken in response to a proposed tender offer which would result in an extraordinary transaction. Item 7 suggests that:

> If no agreement in principle has yet been reached, the possible terms of any transaction or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuance of such negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient.

17 C.F.R. § 240.14d-101 (1985).

146. *See supra* notes 10–13 and accompanying text.

be obligated to make every effort to keep negotiations a secret until there is agreement in principle. If unusual market activity develops, or if the corporation wants to trade its own stock, however, there should be a legal obligation to make prompt disclosure.

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